

Practice

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Expedited Fraud Examinations: A Call for the Return to the Rack and Screw?

The IRS Office of Fraud/Bank Secrecy Act recently released a memorandum¹ to the IRS Examination Directors emphasizing the importance of taking “timely actions on potential civil and criminal fraud cases.” The memorandum² is intended to provide interim guidance in the development of criminal and civil cases and to supplement the Fraud Handbook contained in the Internal Revenue Manual (IRM 25.1.2.1). The number of cases in fraud development status (which are exempt from over-age determinations) has increased significantly, in part, because many of these cases involve complex factually intensive situations with multiple entities and tax years. Many involve actions by the taxpayer or others designed to make it difficult to discover what actually may have transpired. Every potential fraud examination requires a thorough examination of not only what transpired but, almost more importantly, why something did or did not transpire.

The IRS is now emphasizing that fraud examinations must be worked on an “expedited basis” noting that the government’s most successful fraud cases occur where the examiner, with the support of their group manager, takes “timely and appropriate actions” in case development. Has “tax enforcement” replaced the better judgment of “tax administration”? The proper development and analysis of relevant facts and circumstances in a civil fraud examination simply takes time. Sometimes it takes a lot of time. Is this to be the tax fraud version of the “bum’s rush” to a fraud determination?



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Once fully developed, the facts can tend to get in the way of a fraud determination. Why take the time to evaluate all the facts when you have been encouraged to close the civil case out of your inventory by asserting a civil fraud penalty or making a criminal referral? Let others in the tax system make the final determination. However, once a case is labeled as a “fraud” case, it’s difficult for others within the government to resolve it without including a fraud component in the resolution. Can a more expedited process be fair?

Tax practitioners must understand the process by which a civil tax case winds its way through the system. Identifying the decision-makers and the factors they consider important may have an impact on the ultimate resolution of the examination. There is no substitute for mastering the facts and anticipating which, if any, “badges of fraud” may arise so as to be able to prepare a cogent response during the civil examination. Filing current year returns during the examination requires extreme judgment since they will have an impact, although not always a taxpayer-favorable impact, on the process. Of equal importance, counseling a client not to perpetuate possible badges of fraud during the investigation, including falsifying, destroying or altering records, continuing questionable practices into the present and future years, or transferring or concealing assets under investigation may be the difference between a civil resolution and a criminal referral.

Elements of Tax Evasion. “Tax avoidance” generally refers to legally permissible conduct to reduce one’s tax liability while “tax evasion” refers to willfully and knowingly fraudulent actions designed to reduce one’s tax liability. A classic description of “tax avoidance” was penned by Judge Learned Hand:

Anyone may arrange his affairs that his taxes shall be as low as possible. He is not bound to choose the pattern which best pays the Treasury, there is not even a patriotic duty to increase one’s taxes. Over and over again courts have said that there is nothing sinister in so arranging affairs has to keep taxes as low as possible. Everyone does it, rich and poor alike, and all do right, for nobody owes a public duty to pay more than the law demands.³

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While the IRS has conceded that “avoidance of taxes is not a criminal offense” and “any attempt to reduce, avoid, minimize or alleviate taxes by legitimate means is permissible,” the IRS historically established two separate proceedings by which to determine whether one person’s “tax avoidance” has become the government’s alleged “tax evasion.” There are various common factors between civil fraud examinations and criminal investigations and the process by which an

examination uncovering civil fraud may be transformed into a criminal tax investigation. The IRM notes a “fine distinction” between tax avoidance and tax evasion:

One who avoids tax does not conceal or misrepresent. He shapes

events to reduce or eliminate tax liability and, upon the happening of the events, makes a complete disclosure. Evasion on the other hand involves deceit, subterfuge, camouflage, concealment, some attempt to color or obscure events, or make things seem other than they are. For example, the creation of a bona fide partnership to reduce the tax liability of a business by dividing the income among several individual partners is tax avoidance. However, the facts of a particular case may show that an alleged partnership was not in fact established and that one or more of alleged partners secretly returned his/her share of the profits to the real owner of the business, who in turn did not report this income. This would be an instance of attempted evasion.⁴

The basic elements of tax evasion are set forth in Code Sec. 7201,⁵ namely, (1) the existence of a tax deficiency, (2) an affirmative act constituting an evasion or attempted evasion of the tax, and (3) willfulness.⁶ The taxpayer’s state of mind or *mens rea* required for the imposition of the civil fraud penalty is identical to what must be proven in a criminal prosecution for tax evasion under Code Sec. 7201.⁷ While “willfulness” for criminal purposes is defined as a “voluntary, intentional violation of a known legal duty,”⁸ “willfulness” in the civil fraud arena has been similarly defined as an “intentional wrongdoing on the part of the taxpayer with the specific purpose to evade a tax believed to be owing.”⁹

Although a conviction under Code Sec. 7201 requires an affirmative act evidencing an intent to conceal income from the imposition of tax,¹⁰ a civil fraud penalty may be imposed where the taxpayer did not even commit an affirmative act of fraud.¹¹ The better view, however, is that some affirmative act is also required to impose the civil fraud penalty.¹² Thus, for all practical purposes, the government has to prove virtually the same elements to establish either civil fraud or criminal tax evasion.

The Road from a Civil Examination to a Criminal Investigation. The IRS has historically maintained a fraud referral program involving cases initiated by the civil examination and collection functions of the IRS, that are subsequently referred to IRS Criminal Investigation (CI) for criminal investigation and possible prosecution by the Department of Justice. When a revenue agent or revenue officer investigates a case and determines there are “firm indications of fraud,” they are to “refer” the case to CI for a criminal investigation.¹³

The Webster Report’s 1999 review of CI and the fraud referral program highlighted the need for improvement.¹⁴ The Webster Report cited systemic disincentives in the civil audit process for making referrals to CI. For example, the civil revenue agent was responsible for ensuring that no civil statute of limitations expires without written notification to the taxpayer, but once CI accepted a referral for investigation, the civil agent lost control over this significant legal issue. As such, a civil agent was likely to simply keep the case, finish the audit and settle it with the taxpayer to avoid issues regarding the statute of limitations.¹⁵ One outgrowth from the Webster Report was the creation of Fraud Referral Specialists, now referred to as Fraud Technical Advisors (FTA), coordinating activities on behalf of both the civil and the collection functions of the IRS. FTAs have been selected to target civil fraud cases for civil fraud penalty and criminal referral potential. There are now at least 64 FTAs who act as consultants to revenue agents conducting civil examinations. The FTA assists the examining agent in fraud case development, identifying “badges of fraud,” often working behind-the-scenes coordinating the gathering of documentation and the interviewing of witnesses, including the taxpayer.

Knowing that an FTA could be consulting on an audit having issues with criminal potential, the issue of whether the taxpayer should submit to an interview by the civil agent is quite sensitive. The taxpayer may be forced to submit to an interview,¹⁶ but if asked

a question that may be incriminating, the taxpayer should likely assert constitutional protections to avoid answering the questions. Claiming a Fifth Amendment privilege, however, may merely confirm the agent’s suspicions and could encourage the agent’s referral to CI. Thus, the best course of action is often to allow experienced tax counsel to handle the interactions with the agent in hopes of persuading the agent to gather information through alternative means.

Expedited Processing. The recently released IRS Office of Fraud/Bank Secrecy Act memorandum instructs civil examiners to initiate a discussion with their group manager when the “first indication of fraud” is revealed and update their cases to fraud development status, when warranted. The fraud development examination process is to occur on an “expedited basis” utilizing the following guidance set forth in the memorandum:

First Indications of Fraud. The examiner is to initiate a discussion with their group manager and the local Fraud Technical Advisor (FTA) when the “first indications of fraud” are discovered. (IRM 25.1.2.1(2)).

Original Returns. Case files that are part of a criminal referral must include original tax returns while civil fraud penalty case files should contain the original returns.

Action Plan. A “plan of action” should be jointly developed as early as possible to document the affirmative acts of fraud. An integral part of the plan is establishing that sufficient affirmative acts exist to confirm fraud. The plan should be a joint effort of the examiner, the group manager and the FTA. The action plan will help guide the case to its appropriate conclusion in a timely manner. It is important to note that the role of the FTA can be more than advisory or consultative. The jointly developed action plan can and should specify any direct assistance the FTA will provide. The action plan should be retained in the work papers. It should be noted that some cases may not require a face-to-face meeting with the FTA. While consultations over the phone or email are possible, face-to-face contact is recommended.

Fraud Development Status. When it is agreed that the potential for fraud exists between the examiner, the group manager and the FTA, the case will

be updated to Fraud Development Status (IRM 25.1.2.1(6)). IRS Form 11661 is used to document the FTA's involvement and to document the decision to update the case to Fraud Development Status. However, cases should not be placed into or out of Fraud Development Status without consulting the FTA. The reasons and the decision to return a case out of Fraud Development Status should be documented on the Form 11661. If a disagreement exists on whether a case should or should not be in a fraud development status, the ultimate decision rests with the group manager.

Criminal Referral. The examiner, with assistance from the FTA, must know when to suspend action on a case and prepare a criminal referral when there is a firm indication of fraud. If the examiner stops too soon, all information necessary to document firm indicators (affirmative acts) of fraud may not be developed sufficiently for IRS Criminal Investigation (CI). IRM 25.1.2.1(8) advises that the examiner or group manager should not obtain advice and/or direction from CI for a specific case under examination. The FTA is available for this consultation.

Consideration of the Fraud Penalty. If a criminal referral is not warranted, the FTA can assist the examiner to ensure the civil fraud penalty is properly considered and developed.

Badges of Fraud. The "badges of fraud" that the FTA may be reviewing with the civil agent during the course of a civil examination cover a wide range of issues. The IRM Fraud Handbook¹⁷ lists six categories for these badges of fraud, including: (1) income, (2) expenses or deductions, (3) books and records, (4) allocations of income, (5) conduct of the taxpayer, and (6) methods of concealment. Badges of fraud regarding income issues tend to focus on the omission of entire sources of income, unexplained increases in the taxpayer's net worth over a period of years, expenditures substantially in excess of the taxpayers financial resources, or unexplained bank deposits substantially exceeding the taxpayer's reported income. Other indicia of fraud include the cashing of

checks at check cashing facilities or unrelated banks contrary to normal business practices.

With regard to claimed expenses or deductions, taxpayers who deduct substantial amounts of personal expenditures as business expenses, claim fictitious deductions, or seek dependency exemptions for nonexistent, deceased or self-supporting persons (or family pets) also attract attention in a fraud examination. Similarly,

with respect to badges of fraud related to books and records, the fraud examination often uncovers multiple sets of books (e.g., one for the taxpayer's bank inflating net income, one for the IRS understating the same income and one for themselves so they actually know the financial health of their business activities), or false invoices, purchase orders, gift receipts, etc. Also meriting extra scrutiny are taxpayers having books and tax returns do not reconcile or who issue checks to third parties that are then returned and endorsed back to the taxpayer. Regarding allocations of income, the fraud spotlight may be directed at distributions of profits to fictitious parties or inclusions of income or deductions in a related taxpayer's return, where the difference in tax rates is substantial.

The conduct of the taxpayer during an examination can rapidly transform a civil inquiry into a criminal investigation. This conduct may include taxpayers who make false or misleading statements, provide false documents, try to hinder examinations by failing to answer important questions, repeatedly canceling appointments, refusing to provide records or consistently omitting key records, or even threatening potential witnesses. For taxpayers who argue a good faith reliance on their accountant or lawyer, the IRS will analyze whether the taxpayer actually followed the advice given or made a full disclosure of the relevant facts to their professional. The IRS will also consider the tax sophistication, education, training and experience of the taxpayer, whether there was any attempt to transfer or conceal assets either before or during the audit, and whether the amounts involved as well as the time period at issue were so substantial as to negate a claim of innocence or mistake.

As for the different badges of fraud dealing with methods of concealment, if any of these apply, there is a significant likelihood of a criminal referral. Such badges include placing assets in the name of a

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nominee, the fraudulent conveyance of assets in anticipation of a tax assessment or during an investigation, use of secret bank accounts or entities—particularly off-shore entities—to disguise the source and destination of a financial transaction, and use of nominees for property or banking transactions.

Warning Signs of a Criminal Referral. A long, unexplained period of silence after much investigative activity by the revenue agent or revenue officer should cause a degree of concern that an FTA has been consulted. Since civil agents are extremely discreet about informing the taxpayer's representative that they are contemplating a criminal referral, experienced representatives have learned to identify certain activities by the agent, prior to the period of silence, as indicating a potential referral to CI. In cases involving allegations of unreported income, the agent's request and summoning and photocopying of all bank account information could raise the specter of a criminal referral, especially if the agent has stumbled upon a "side account" which was not accounted for in determining the taxpayer's income. By summoning the information, the agent ensures that the case file will include copies of bank statements, deposited items, deposit slips, bank wire confirmations and canceled checks, which could be evidence of the unreported income.

A civil agent's questions about the taxpayer's "lifestyle," expenditures and other information may indicate that the agent is undertaking a financial status type of an examination¹⁸ to determine whether the income reported on the return supports the taxpayer's financial lifestyle. If the revenue agent requests information as to the taxpayer's assets and liabilities at the beginning and end of a tax year, this could suggest that the agent has determined that the taxpayer's books and records do not adequately reflect income and that an indirect method of proof of income, such as a net worth method, is being considered. The net worth and expenditures methods are well-recognized indirect methods of proof that have often been used in reconstructing income in criminal tax cases.¹⁹

A taxpayer's representative may be alerted when the civil agent requests information such as supplier invoices, price lists, customer ledger cards and other information that could be used as circumstantial evidence to prove unreported gross receipts. Also, if the civil agent requests the taxpayer either to submit to an interview or to answer questions in writing that relate to the taxpayer's knowledge or intent of the facts and circumstances surrounding alleged unreported

income or false deductions; or the agent refuses to discuss in detail the status of the audit and the possibility of concluding the audit in the near future, a criminal referral may be under consideration.

Parallel Proceedings—Increased Aggressiveness in Tax Investigations. The IRS has dramatically altered its practices in conducting criminal investigations. It had been long-standing IRS policy that the IRS did not engage in parallel civil and criminal enforcement activity. If a civil audit unearthed a "firm indication" of fraud, the revenue agent has been directed to suspend the examination without telling the taxpayer and would prepare a Form 2797 ("Referral Report of Potential Criminal Fraud Cases"). The FTA is available to assist the agent in preparing this report which sets forth a detailed factual presentation of factors supporting the fraud referral, including (1) affirmative acts of fraud; (2) taxpayer's explanation of the affirmative acts; (3) estimated criminal tax liability; and (4) method of proof used for income verification.²⁰

The fraud referral report is then transmitted to a CI Lead Development Center and is quickly followed by a conference between the referring civil agent and their group manager, the evaluating CI special agent and their supervisory special agent and the FTA. In this conference, tax returns, evidence and factors leading to the referral are reviewed and discussed. Shortly thereafter, the same parties meet again at a disposition conference to discuss CI's decision to accept or decline the referral. IRS Counsel may also be invited to this meeting to offer legal advice, if it is deemed necessary.²¹ A final decision as to whether the referral meets or does not meet the criminal criteria typically occurs shortly after the disposition conference. This period of time, when the fraud referral is being considered, is usually marked by a long, unexplained silence on the part of the civil agent, which may indicate to the taxpayer's representative that a referral has been made to CI.

Recently, the IRS has moved from this policy to a nearly opposite mode of operation. It was long thought bad policy to risk the perception that the IRS civil tax enforcement activities might be perceived as being used to develop criminal charges. Fundamental Constitutional rights not to provide evidence against oneself, to counsel, and to due process, are at some risk when a taxpayer is compelled to provide information to government taxing authorities. As a result, it had long been the IRS's practice for civil examinations to defer to criminal investigations.

In a dramatic and remarkable change, the IRS has shifted to practices that often include parallel civil and criminal proceedings. The IRM, in statements dated within the last two years, includes a provision that “[t]he criminal and civil aspects of a case do not present an either/or proposition. Rather, the criminal and civil aspects of a case should be balanced to the extent possible without prejudicing the criminal prosecution.”²² Now, instead of the cessation of civil activity during the pendency of a criminal investigation, the IRS’s civil and criminal enforcement activities are expressly coordinated.²³

Recent language in the IRM states that “a fraud case begins” when an IRS revenue agent engaged in civil examination or collection activities recognizes “affirmative indications and acts of fraud by the taxpayer.”²⁴ The IRM offers extensive guidance to the revenue agents as to how to identify or seek out information that may establish such “affirmative indications and acts of fraud.” Revenue agents involved in civil examinations are told that the “discovery and development of fraud cases are a normal result of effective investigative techniques” and that their efforts “should be designed to disclose not only errors in accounting and application of tax law, but also irregularities that indicate the possibility of fraud.” To expedite the process, they are encouraged to seek the assistance of FTAs in these efforts.²⁵

Only after the revenue agent’s efforts lead to a conclusion that there is a “firm indicator” of fraud, beyond what is depicted by the IRM as “affirmative indications” of fraud, does the IRM state that a criminal referral should occur.²⁶ Until then, what a taxpayer perceives as a typical IRS audit may well involve a revenue agent who is looking to build a criminal case.²⁷ The commencement of a criminal investigation still may not stop the civil enforcement efforts, however. In a recent interview, the Chief of IRS CI said that the government now has over 200 ongoing parallel civil and criminal proceedings.²⁸ Rather than cease the civil process while the criminal investigation goes forward, the efforts may now be more commonly coordinated.

A significant distinction between civil and criminal fraud is the differing burdens of proof. In a criminal prosecution, fraud must be proven beyond a reasonable doubt.²⁹ In a civil fraud penalty case, however, the government must prove civil fraud by “clear and convincing evidence.”³⁰ However, if the government establishes that any portion of an underpayment of tax is attributable to fraud, then the entire underpayment

is treated as attributable to fraud, unless the taxpayer establishes by preponderance of the evidence that it is not attributable to fraud.³¹

The timing of which case proceeds can prove to be crucial. If the criminal case proceeds first, a conviction after a jury verdict or guilty plea under Code Sec. 7201 essentially precludes the defendant from litigating the issue of civil fraud in a subsequent civil tax proceeding, for the tax year of conviction.³² The defendant, however, may still litigate the tax deficiency in the civil proceeding.³³ The collateral estoppel doctrine which results in a finding of civil fraud is based on the fact that the willfulness requirement of Code Sec. 7201 includes the specific intent to evade or defeat the payment of tax, which is the standard for proving fraud for purposes of the civil fraud penalty.³⁴ If the Government proves willfulness under Code Sec. 7201 beyond a reasonable doubt in the criminal case, then that finding necessarily meets the clear and convincing standard of the civil fraud case. On the other hand, a conviction for only subscribing to a false return under Code Sec. 7206 does not collaterally estop a taxpayer from contesting the civil fraud penalty since the elements for this offense do not mirror those for the civil fraud penalty.³⁵

Some Limits Exist. In the context of parallel proceedings, IRS must remain “mindful” of the decision in *N.J. Tweel*.³⁶ In *Tweel*, an IRS CI special agent was involved with the civil audit of the defendant, but withdrew. The accountant representing the defendant at the audit directly asked whether a special agent was involved, and the civil revenue agent responded in the negative. As the court described, the revenue agent “did not disclose ... that this audit was not a routine audit to which any taxpayer may be subjected from time to time,” but rather was being conducted at the specific request of the Department of Justice. The defendant’s records were subsequently made available to the revenue agent for copying.³⁷

The Fifth Circuit stated: “It is a well established rule that a consent search is unreasonable under the Fourth Amendment if the consent was induced by the deceit, trickery or misrepresentation of the Internal Revenue agent.”³⁸ The court concluded that the revenue agent’s response to the accountant’s inquiry, while the literal truth, “was a sneaky deliberate deception by the agent ... and a flagrant disregard” of the defendant’s rights.³⁹ The court suppressed the documents and reversed the conviction. The *Tweel* decision at one time had sufficient force to make the IRS wary of proceeding with parallel civil and

criminal enforcement. The IRS today goes forward with much less temerity. The IRS does not suggest, however, that *Tweel* is not still good law, offering some safeguards to taxpayers.

CI Acceptance of a Criminal Referral. What factors are most likely to influence a decision by CI to proceed with a criminal investigation? A necessary element of every criminal tax felony, including tax evasion, is willfulness. This element is usually proven through evidence of the taxpayer's conduct. The more egregious the conduct, the more likely it is that the resulting prosecution will be successful. Thus, CI looks for a pattern of understatements of income or nonfiling over a period of years (usually three or more) as evidence of willfulness.⁴⁰ In contrast, where a taxpayer understated income for a single year and claims there was a miscommunication with a bookkeeper or gives some other plausible explanation for the income understatement, the government is presented with a more difficult case to prove willfulness. A mere understatement of income by itself, even if it occurs over several years, is generally not enough to justify a CI investigation. To buttress its argument for willfulness, the government often looks for other badges of fraud such as acts of concealment, destruction of records, altered documents and other conduct from which willfulness may be inferred.

Another factor CI considers in determining whether to accept a criminal referral is the *amount* of the tax loss involved. The IRM section on fraud referrals states that the primary objective of CI is an investigation leading to the prosecution, conviction and incarceration of individuals who violate criminal tax laws and related offenses.⁴¹ The IRM further states that since the Federal Sentencing Guidelines tie the period of incarceration to the monetary value of a tax violation, the amount of "tax loss" should be higher than minimum criteria set forth in the government's internal Legal Enforcement Manual. Moreover, CI recognizes that U.S. Attorneys are reluctant to use their offices' resources to prosecute individuals who could not be sent to prison.⁴² The IRM, therefore, instructs persons reviewing a criminal referral to determine whether, based on the tax loss the taxpayer is likely to be incarcerated if convicted.

How much "tax loss" is enough to make incarceration likely? Under the Federal Sentencing Guidelines, the threshold amount for incarceration is actually quite low considering criminal investigations typically cover multiple tax years and all related entities. For those convicted of tax crimes, a tax loss (generally

defined as 28 percent of the amount of unreported income or false deduction)⁴³ from \$30,000 to \$80,000 would likely result in a sentencing offense level requiring the defendant to serve a sentence of at least five months in custody and five months in home detention or at a community correction facility.⁴⁴ As such, practically all cases investigated for criminal tax violations have the probability of landing the targeted individual in prison. Since the amount of tax loss is the primary factor in determining the period of incarceration, the tax loss amount often leads a determination to accept a criminal referral.

CI enforcement initiatives also play a significant role in determining whether a civil fraud referral is accepted for criminal investigation. The most significant CI enforcement priority relates to legal source tax crimes. These involve the traditional "garden variety tax criminal" who is involved in a legitimate business, but engages in illegal conduct to divert income, evade filing and payment obligations or assist others in similar conduct. This tax compliance program is actively focused on abusive trust schemes,⁴⁵ which are elaborate tax evasion schemes set up to give the appearance of legitimacy through the use of a series of trusts, diversion of unreported income to offshore banks and other foreign financial institutions,⁴⁶ health care fraud,⁴⁷ employment tax fraud,⁴⁸ nonfiler cases, and tax return preparer cases.⁴⁹

Another general enforcement program is referred to as the illegal-source financial crimes program, which includes narcotics-related investigations, money laundering investigations and task forces aimed at investigating the use and movement of funds to support terrorist activities. Certain industries have been the focal point of significant interest from CI. These industries include the restaurant industry,⁵⁰ the construction industry,⁵¹ and insurance and Medicare fraud in the medical profession.⁵² Although not currently stated as an enforcement priority, CI has historically investigated a number of cases involving the garment industry, attorneys and doctors involved in handling personal injury cases and others.

It is the government's objective in criminal tax prosecutions to get the maximum deterrent value from every case that is prosecuted,⁵³ which may be accomplished, in part, by targeting individuals who are perceived as being "highly visible." The decision to accept a case for criminal investigation may be influenced by the taxpayer's occupation, level of education, visibility within a particular community, high standing in a particular industry, either perceived or

actual financial success, notoriety in a non-tax field, previous criminal background and other factors that could cause the government to “make an example” of a particular defendant.

During the 1990s, CI investigated a number of National Basketball Association referees for criminal tax violations relating to their exchanging of first-class airline tickets for lesser-priced coach tickets. The government achieved significant deterrence from these cases when an article concerning the investigations and how they affected the lives of the targeted referees was featured in Sports Illustrated magazine.⁵⁴ The government’s goal of maximizing the “deterrent effect” has often been served by pursuing persons in highly visible positions and obtaining publicity of these cases to achieve the broadest possible impact on compliance.⁵⁵

Can an expedited civil examination / fraud referral process be fair? Can you actually determine whether a civil examination will result in a criminal investigation? Can you predict the future? Appropriate tax administration dictates the proper development of all relevant facts and circumstances underlying a possible fraud determination.

Changes to long-standing practices, made in an era of heightened enforcement, may undermine sound policies in a way that resonates more profoundly than the harms that the government is seeking to redress.

An examination that uncovers egregious facts may result in a civil fraud penalty (or less) while another involving a sympathetic situation might result in a criminal prosecution. Both will involve an often-frustrating process that by itself may destroy the personal relationships and business affairs of the taxpayer. Proper development and analysis of relevant facts and circumstances in a civil fraud examination requires considerable effort and judgment. Given the consequences of this determination, this effort should be respected, not disregarded.

The government is concerned by conduct in recent years that it perceives as abusive by taxpayers and tax practitioners. Integral to the fair operation of the tax system, however, is the perception and reality of uniform and fair treatment by the IRS. Changes to long-standing practices, made in an era of heightened enforcement, may undermine sound policies in a way that resonates more profoundly than the harms that the government is seeking to redress. A rush to judgment combined with a return to the rack and screw methods of information gathering just might not be considered progress.

ENDNOTES

¹ SBSE-25-0806-033.

² The memorandum dated August 21, 2006 was not released until February 12, 2007 and is slated to expire August 21, 2007.

³ *E.F. Gregory*, CA-2, 69 F2d 809, 1934 CCH ¶9180. *Aff’d*, SCt, 35-1 USTC ¶9043, 293 US 465, 55 SCt 266.

⁴ IRM 9781 §412 (Jan. 18, 1980).

⁵ All references to the Internal Revenue Code refer to the Internal Revenue Code of 1986, as amended.

⁶ *M.C. Sansone*, SCt, 65-1 USTC ¶9307, 380 US 343, 85 SCt 1004.

⁷ *W. Kahr Est.*, CA-2, 69-2 USTC ¶9594, 414 F2d 621, 627 (2nd Cir. 1969).

⁸ *P. Pomponio*, SCt, 76-2 USTC ¶9695, 429 US 10, 12, 97 SCt 22.

⁹ *G.C. McGee*, 61 TC 249, Dec. 32,219. *Aff’d*, CA-5, 75-2 USTC ¶9723, 519 F2d 1121.

¹⁰ *F.L. Hook*, CA-6, 86-1 USTC ¶9179, 781 F2d 1166.

¹¹ *R.W. Paddock*, 51 TCM 17, Dec. 42,512(M), TC Memo. 1985-586.

¹² *L.T. Zell II*, CA-10, 85-2 USTC ¶9698, 763 F2d 1139, 1143, 1145-46 (mere failure to

file not sufficient to impose fraud penalty, but penalty could be imposed on taxpayer who filed withholding certificate); *J. Solomon*, CA-6, 84-1 USTC ¶9450, 732 F2d 1459; *J.B. Miller*, 94 TC 316, 335-37, Dec. 46,435, (1990) (nonfiling of returns, even over a long period of time is not subject to the fraud penalty; but failure to file accompanied by the affirmative act of filing false Forms W-4 to prevent withholding did justify imposition of the fraud penalty).

¹³ Review of the Internal Revenue Service’s Criminal Investigation Division, April 1999 (the “Webster Report”), citing IRM 104.2.4.3; IRM 4.4565.21(1).

¹⁴ Webster Report, citing Dubin, Graetz & Wild, *The Changing Face of Tax Enforcement, 1978-1988*, 43 TAX LAW. 893 (Summer 1990).

¹⁵ Webster Report at 20. The Webster Report also noted that the civil agent’s “cycle time” (the duration of an audit) was also unreasonably increased by the referral of a case to CI, because the CI investigation time was included in the computation of cycle time

and this collided with civil examination management objectives to keep cycle time down on all civil cases.

¹⁶ Code Sec. 7602.

¹⁷ IRM 25.1.2.2 (01-01-2003) Indicators of Fraud.

¹⁸ See Code Sec. 7602(e).

¹⁹ IRM 9.5.8.6.2 Net Worth Investigation (03-19-1999); *M.L. Holland*, SCt, 54-2 USTC ¶9714, 348 US 121, 75 SCt 127.

²⁰ IRM 25.1.3.2 Preparation of Form 2797 (01-01-2003).

²¹ IRM 25.1.3.3 Referral Evaluation (01-01-2003).

²² IRM 38.3.1.8.

²³ *E.g., id.*

²⁴ IRM 25.1.2.1(1).

²⁵ IRM 25.1.1.1.

²⁶ IRM 25.1.3.2.

²⁷ The more aggressive practices by the IRS, the damage to the tax system, and practical guidance for defense attorneys, is set out in a very thoughtful article by Martin A. Schainbaum, *The Reverse Eggshell Audit: The Dangers of Parallel Proceedings*, J. TAX PRAC.

ENDNOTES

- & PROC., Dec. 2005–Jan. 2006, at 55.
- ²⁸ S. Joyce, *IRS Increases Use of Parallel Proceedings as Part of Enhanced Enforcement Efforts*, DAILY TAX REPORT (BNA), Dec. 7, 2005.
- ²⁹ M.L. Holland, SCt, 54-2 USTC ¶9714, 348 US 121, 75 SCt 127.
- ³⁰ Code Sec. 7454(a); USTC R. PRAC. & PROC. 142(b); J. Edelson, CA-9, 87-2 USTC ¶9547, 829 F2d 828, 832. *Aff'g*, 51 TCM 1109, Dec. 43,088(M), TC Memo. 1986-223; D.M. Castillo, 84 TC 405, Dec. 41,940 (1985).
- ³¹ S.L. Morrow, 26 TCM 1222, Dec. 28,690(M), TC Memo. 1967-242. See also Code Sec. 6663(b).
- ³² S. Lefkowitz, CA-5, 64-2 USTC ¶9623, 334 F2d 262. *Cert. denied*, 379 US 962; 85 SCt 650 (1965); T. McKinon, 55 TCM 1345, Dec. 44,923(M), TC Memo. 1988-323 (granting summary judgment against taxpayer for fraud penalties on account of conviction for all years).
- ³³ F. Delgado, 55 TCM 155, Dec. 44,591(M), TC Memo. 1988-66.
- ³⁴ Code Sec. 6663.
- ³⁵ J.T. Wright, 84 TC 636, Dec. 42,013 (1985) (“Thus, the crime is complete with the knowing, material falsification, and conviction under Section 7206(1) does not establish as a matter of law that the taxpayer violated the legal duty with an intent, or in an attempt, to evade taxes.”).
- ³⁶ N.J. Tweel, CA-5, 77-1 USTC ¶9330, 550 F2d 297.
- ³⁷ *Id.*, at 298.
- ³⁸ *Id.*, at 299.
- ³⁹ *Id.*, at 300.
- ⁴⁰ Holland, *supra* note 29; P.C. Magnus, CA-2, 66-2 USTC ¶9660, 365 F2d 1007.
- ⁴¹ IRM 25.1.3.1.1 Background Criminal Referrals (01-01-2003).
- ⁴² *Id.*
- ⁴³ Federal Sentencing Guideline §2T1.1(c)(1).
- ⁴⁴ In this example, the federal sentencing guidelines in effect for November 1, 2001 for a defendant having a tax loss in the \$30,000–\$80,000 range would be sentenced to an offense level of 12, Zone C, after taking into account the 2-level decrease for acceptance of responsibility. The five months of incarceration and five months in home detention and/or community correction center is the best sentence one can receive at this offense level.
- ⁴⁵ IRM 9.5.3.2.4 Foreign and Domestic Trusts (4-9-1999).
- ⁴⁶ See Rev. Proc. 2003-11, IRB 2003-4, 311; 2003-1 CB 311, which provided for an amnesty period for the reporting of credit cards and debit cards tied to offshore bank accounts and other foreign arrangements used to evade income tax. Since the amnesty period expired on April 15, 2003, the Internal Revenue Service Civil and Criminal Divisions are focused on taxpayers who did not come forward to voluntarily disclose their unreported income maintained in offshore banks.
- ⁴⁷ IRM 9.5.3.2.7 Health Care Fraud (7-16-2002).
- ⁴⁸ IRM 9.5.3.3.1, *et seq.* Employment Tax Initiative (4-9-1999). Criminal employment tax investigations are focused on employee leasing companies that failed to pay over taxes withheld from employees, the pyramiding of employment taxes by businesses that use multiple corporate and other entities to stay at least one step ahead of the taxing authorities, failure to withhold social security taxes and other employment taxes based on time-worn tax protestor arguments and other similar cases.
- ⁴⁹ IRM 9.5.3.2.11 Return Preparers (7-16-2002). The primary purpose of the return preparer fraud program is to protect revenue by identifying and pursuing investigations of abusive return preparers. Preparer fraud generally involves the orchestrated preparation and filing of false federal income tax returns by return preparers who claim excessive expenses, deductions, credits and other false statements on returns while diverting a portion of the refund, charging excessive fees and engaging in other fraudulent conduct.
- ⁵⁰ Internal Revenue Service Fact Sheet—Tax Fraud in the Restaurant Industry, www.treas.gov/irs/ci.
- ⁵¹ Internal Revenue Service Fact Sheet—Construction Industry, www.treas.gov/irs/ci.
- ⁵² The Medical Profession and Tax Schemes FS-2003-12, May 2003, www.treas.gov/irs/ci.
- ⁵³ U.S. Department of Justice Criminal Tax Manual, *The Federal Tax Enforcement Program*, Section 6-4.010, p. 2-5 (1994).
- ⁵⁴ Leigh Montville, *Called for Traveling*, SPORTS ILLUSTRATED, April 1998.
- ⁵⁵ U.S. Department of Justice Criminal Tax Manual, *The Federal Tax Enforcement Program*, Section 6-4.010, p.2-5.